CHAPTER 17

RETIREMENT SAVINGS

The Treasury Department proposals would maintain the current tax-favored treatment of retirement saving, and would expand the tax-deductible amounts that may be placed into individual retirement accounts (IRAs). Cash or deferred arrangements, which effectively allow employees to avoid limits on IRAs, would be repealed. Other revisions would provide more consistent treatment of various types of retirement plans. Uniform rules, including an excise tax on premature distributions, would govern distributions from various types of plans, and more uniform contribution limits would be established. The overall limit on non-top-heavy defined benefit and defined contribution plans would be eliminated and an excise tax would be imposed on annual distributions in excess of specified limits. To preclude employers from receiving unintended tax benefits by overfunding plans, a ten percent additional tax would be imposed on plan funds reverting to an employer upon plan termination. Finally, qualified pension plans would be permitted to use benefits forfeited by a separated employee to increase the benefits of other employees.

INCREASE INDIVIDUAL RETIREMENT ACCOUNT (IRA) LIMITS

General Explanation

Chapter 17.01

Current Law

An individual generally is permitted to deduct annual contributions to an individual retirement account or annuity (IRA) up to the lesser of $2,000 or 100 percent of the individual's annual compensation. Thus, if a married individual and his or her spouse each receive compensation during a year, each may make separate deductible contributions to his or her own IRA up to the lesser of $2,000 or 100 percent of compensation.

If an individual receives no compensation during a year, the individual generally is not allowed to make a deductible IRA contribution for such year. Special "spousal IRA" limits, however, provide that if a married individual's spouse earns no compensation during a year and if the married couple files a joint return for the year, the individual may deduct annual IRA contributions up to the lesser of $2,250 or 100 percent of the individual's annual compensation. The contributions may be allocated in any fashion between the individual's IRA and the nonearning spouse's IRA, except that no more than $2,000 may be contributed to either IRA.

The special spousal IRA maximum limit of $2,250 is not available if the married individual's spouse has compensation income during the year. Thus, if a husband and wife each have compensation income, each is subject separately to the $2,000 and 100 percent of compensation limits on deductible contributions. As a consequence of this rule, a married couple with a nonearning spouse is permitted to make larger total deductible IRA contributions than a married couple with a spouse who has compensation income of less than $250.

Reasons for Change

The tax benefits applicable to IRAs are intended to encourage individuals to make adequate provision for their retirement security. Savings for this purpose also contribute to the formation of investment capital needed for economic growth. For many individuals, including individuals who are covered by employer-maintained retirement plans, IRAs are an important element in an overall strategy to provide for retirement security. The use of IRAs for retirement saving should thus not only be encouraged, but made available on a broad and consistent basis.

The existing limitations on IRA contributions are illogical and inequitable as applied to married couples. The relatively minor allowances for a spousal IRA fail to recognize the important economic contributions made by nonearning spouses. Moreover, they are inconsistent with other rules of current law under which married couples are treated as an economic and taxpaying unit. Thus, a husband and wife that each earn $10,000 can make aggregate IRA contributions of $4,000 under current law. A couple with the same joint income of $20,000, all of it earned by one spouse, can make aggregate IRA contributions of only $2,250. A third couple, also with $20,000 of joint income, but with one spouse earning only $200, is limited even further to a $2,200 aggregate IRA contribution. These disparate results are inconsistent with both the retirement savings policy reflected in IRAs and with general tax principles requiring similar treatment of similarly situated taxpayers.

Proposals

The dollar limit on the deductible IRA contributions that may be made by an individual would be increased from $2,000 to $2,500.

A married individual filing a joint return, including an individual with no annual compensation, would be permitted to take into account his or her spouse's compensation (less the deductible IRA contribution made by such spouse) in determining the deduction limit for such individual. Thus, married couples with aggregate compensation of $5,000 or more would be entitled to the same $5,000 aggregate IRA contribution ($2,500 apiece) regardless of how much of the aggregate compensation was generated by either spouse.

Effective Date

The increased dollar limit on IRA contributions and the spousal compensation rule for married individuals would apply to taxable years beginning on or after January 1, 1986.

Analysis

Increasing the IRA deduction limits would encourage taxpayers to set aside additional amounts in long-term savings. This would not only enhance individual retirement security, but should also contribute to increased capital formation and productivity.

UNIFY RULES FOR QUALIFIED RETIREMENT PLAN DISTRIBUTIONS

General Explanation

Chapter 17.02

Current Law

Current law provides tax-favored treatment with respect to funds set aside under any of several employer-sponsored or individual plans providing for deferred compensation or retirement savings. Such tax-favored plans include qualified profit-sharing, stock bonus, and pension plans (section 401(a)), qualified annuity plans (section 403(a)), tax-sheltered annuities and custodial accounts (section 403(b)), individual retirement accounts and annuities (section 408(a)&(b)), and simplified employee pensions (section 408(k)). Although these tax-favored retirement plans are related in concept and purpose, distributions from the plans are subject to differing requirements and may result in significantly different tax consequences to individual recipients.

Minimum Distribution Requirements. Tax-favored retirement plans are subject to certain minimum requirements concerning the timing and amount of distributions. Qualified profit-sharing, stock bonus, pension, and annuity plans must generally commence distributions no later than the April 15 following the year in which the employee attains age 70-1/2, or, if later, the year in which the employee retires. Benefits thereafter must be distributed under a minimum distribution schedule. Additional rules require minimum annual distributions where the employee dies before benefit distributions have commenced or have been completed. A qualified plan failing to satisfy the minimum distribution rules with respect to a participant may lose its tax-favored status.

Individual retirement accounts (IRAs) and simplified employee pensions (SEPs) must commence distributions no later than the year in which the IRA or SEP owner attains age 70-1/2, without regard to whether such owner has retired. Thereafter, benefits must be distributed under lifetime and after-death distribution schedules similar to those for qualified plans. An IRA or SEP that fails to satisfy the minimum distribution rules does not lose its tax-favored status. Instead, the payee is subject to an excise tax of 50 percent of the amount by which the required distribution exceeds the amount actually distributed.

Benefits provided through tax-sheltered annuities and custodial accounts are not subject to minimum distribution rules for the period during which the original holder of the annuity or custodial account remains alive. If, however, the holder dies before the entire interest in the annuity or account is distributed, distribution rules based on the after-death rules for qualified plans must be satisfied.

Early Distributions. In general, amounts distributed from tax-favored retirement plans are fully taxable to the recipient at the time of distribution. There are a variety of exceptions to this general rule, however, under which certain distributions incur additional taxes and certain others receive more favorable tax treatment than ordinary distributions.

Distributions from an IRA or SEP before the IRA or SEP owner dies, becomes disabled, or attains age 59-1/2 generally are subject to a ten percent additional tax. Similar distributions from a qualified profit-sharing, stock bonus, pension, or annuity plan are subject to an additional tax only in the case of employees owning more than five percent of the employer. Early distributions from tax-sheltered annuities are not subject to any additional tax. Early distributions from tax-sheltered custodial accounts are generally prohibited absent financial hardship or disability.

Lump Sum Distributions. Preferential tax treatment is currently available for certain lump sum distributions from a qualified profit-sharing, stock bonus, pension or annuity plan. Under a special averaging rule, the tax liability on a lump sum distribution is determined as though the individual received the distribution ratably over ten years. In addition, the portion of a lump sum distribution attributable to plan participation before 1974 may be taxed at capital gain rather than ordinary income rates. Whether a lump sum distribution qualifies for favorable treatment is determined under an extensive set of rules, based in part on the employee's age, employment status and years of participation in the plan. Favorable lump sum treatment is not available for distributions from IRAs, SEPs, or tax-sheltered annuities or custodial accounts.

Employer Securities. Current law also provides preferential tax treatment for net unrealized appreciation on employer securities included in a lump sum distribution from a qualified profit-sharing, stock bonus, or pension plan. Such appreciation is not included in income at the time of distribution, but instead is taxable upon subsequent disposition of the securities, ordinarily at capital gain rates. If the distribution is not a lump sum distribution, only the unrealized appreciation on employer securities purchased with employee contributions qualifies for the special treatment. Unrealized appreciation on plan distributions of securities other than employer securities is fully taxable upon distribution.

Basis Recovery. Tax-favored retirement plans are also subject to special rules for the recovery of contributions by the employee that were previously subject to tax. Outside the area of tax-favored retirement plans, amounts not received as annuities before the annuity starting date are generally treated first as a taxable distribution and second as a tax-free recovery of the employee's contributions. This basis recovery rule is reversed, however, for non-annuity distributions from qualified profit-sharing, stock bonus, pension, and annuity plans and tax-sheltered annuities and custodial accounts, so that distributions are treated first as a tax-free recovery of employee contributions.

Tax-favored retirement plans are also granted special treatment for amounts received as annuities after the annuity starting date. Under general basis recovery rules, employee contributions are recovered tax-free on a pro rata basis, in accordance with an exclusion ratio based on the employee's life expectancy at the time distributions commence. An employee's after-tax investment in a tax-favored plan, however, is recovered prior to any taxable distributions, provided that the aggregate amount to be distributed during the first three years exceeds such after-tax investment.

Rollovers. Distributions from a tax-favored retirement plan are not subject to taxation to the extent rolled over to another retirement plan. A complex series of rules governs the extent to which distributions from particular plans may be rolled over as well as the type of plans to which rollovers may be made. In general, these rules are designed to prevent individuals from avoiding restrictions applicable to certain plans by shifting benefits to a plan that is free of the restrictions.

Constructive Receipt. In general, benefits under tax-favored plans are taxable when received. For most plans, receipt occurs for tax purposes only when benefits are actually distributed. The doctrine of constructive receipt is applied, however, to benefits under tax-sheltered annuities and custodial accounts, which may be treated as received either when actually distributed or when made available to the individual. As a consequence, benefits in such plans may be taxable prior to their actual distribution.

Reasons for Change

The current rules for distributions from tax-favored retirement plans are burdensomely complex for taxpayers and inconsistent in their treatment of similarly situated individuals. The current rules also undercut the basic rationale for tax-favored plans, which is the encouragement of savings for retirement.

Uniform Treatment of Distributions. The various tax-favored retirement plans are important components of a general policy to enhance individual retirement security. The current absence of uniformity in the treatment of such plans creates significant disparities among individuals based on the type of plans to which the individuals happen to have access. Uniform rules would eliminate such disparities and also reduce the complexity of the existing rules governing plan distributions. Existing differences in the tax treatment of plan distributions give tax considerations undue influence over an individual's choice of retirement plans. Moreover, they require individuals either to master a complex set of rules or to seek professional advice. In too many cases they may result in a loss of possible benefits. Uniform rules would have the additional advantage of making unnecessary the current restrictions on the shifting of benefits from one plan to another.

The tax-favored status of retirement plans is intended to enable individuals to replace compensation that terminates with retirement. Minimum distribution rules support this rationale by limiting the extent to which tax-deferral on retirement savings can be extended beyond the individual's retirement. Given the purpose of minimum distribution rules, they should apply to all retirement plans receiving tax-favored treatment.

Uniform sanctions should also apply to violations of minimum distribution rules. The sanction of disqualification, however, is too onerous for a plan's failure to satisfy the highly technical requirements. Disqualification may result in adverse tax consequences to all plan participants, even though plan administration generally is outside the control of the participants and the failure may have occurred with respect to only a single participant. Plan disqualification procedures also impose a significant administrative burden on the Internal Revenue Service.

Encourage Retirement Savings. The current favorable treatment of certain plan distributions undercuts retirement saving by encouraging lump sum or early withdrawals. The special basis recovery rules for certain distributions permit accelerated tax-free recovery of employee contributions. This reduces the tax cost of early withdrawals, and permits employees to use tax-favored plans as short-term savings accounts rather than as retirement savings vehicles. The rules permitting deferral of tax on unrealized gain in distributions of employer securities also reduce the tax cost of such withdrawals.

The special ten-year averaging and capital gain provisions for certain lump sum distributions encourage such distributions and thus are inconsistent with the policy to provide individuals with income throughout the entire period of retirement. The original purpose of the capital gain and ten-year averaging provisions was to mitigate the effect of the progressive tax structure on individuals receiving all of their benefits in a single year. The same purpose is now served, however, by permitting individuals to roll over lump sum distributions into an IRA. This results in the individual being taxed only as amounts are subsequently withdrawn from the IRA.

Proposals

All tax-favored retirement plans, including tax-sheltered annuities and custodial accounts, would be subject to uniform minimum distribution rules governing both lifetime and after-death distributions. Thus, distributions from all tax-favored retirement plans would be required to commence no later than the year in which the individual attains age 70-1/2. Thereafter, both lifetime and after-death distributions would have to conform with minimum payout schedules.

The uniform sanction for failure to satisfy the minimum distribution rules would be a 50 percent excise tax, based on the amount by which the minimum amount required to be distributed exceeds the amount actually distributed. The recipient of the distribution would be primarily liable for payment of the tax, with a right, where applicable, to recover the tax from the plan. The current sanction of disqualification for certain plans would be eliminated.

Tax-sheltered annuity contracts, whether they actually are in the form of an annuity contract issued by an insurance company or a custodial account holding regulated investment company stock, would be subject to the same distribution restrictions currently applicable only to such custodial accounts.

Uniform rules would also govern the tax consequences of plan distributions to individual recipients. Thus, distributions would be subject to tax only upon actual receipt. Current application of the constructive receipt doctrine to tax-sheltered annuities and custodial accounts would be eliminated. In addition, the taxable portion of any distribution from a tax-favored plan would be taxed fully as ordinary income. Thus, the special capital gain and ten-year averaging treatment for lump sum distributions and the deferred inclusion of unrealized appreciation on distributions of employer securities would be eliminated.

In calculating the taxable portion of a plan distribution, the generally applicable basis recovery rules, with certain modifications, would apply. Thus, an amount received before the annuity starting date would be treated, first, as a taxable distribution and, second, as a nontaxable return of basis. Annuity distributions after the annuity starting date would be taxed in accordance with the exclusion ratio established when such distributions commenced. In establishing the exclusion ratio for an individual, standardized recovery periods of five, ten, fifteen, and twenty years would be used in lieu of the individual's actual life expectancy; the recovery period for a particular individual would be the period closest to the individual's life expectancy at the time distributions commence. If distributions cease before the individual recovered his entire basis tax-free, the individual, his estate, or his heirs would be entitled to a deduction for the unrecovered basis. If the individual receives benefits for longer than his recovery period, all additional distributions would be fully taxable.

Early distributions would also be subject to uniform treatment. Thus, the taxable portion of a distribution from any tax-favored retirement plan before the individual's death, disability, or attainment of age 59-1/2 would be subject to an additional tax of 20 percent of such taxable portion. However, if the early distribution is used to pay for college expenses incurred by a dependent or for the purchase of the individual's first principal residence, the rate of the additional tax would be reduced to ten percent. In either case, the additional tax would be nondeductible and could not be offset by any deductions or credits otherwise available to the individual.

Individuals generally would be permitted to make a tax-free rollover of funds, within 60 days, from one tax-favored retirement plan to another. Rollovers and transfers would be limited, however, to prevent individuals from avoiding the minimum distribution rules.

The Treasury Department recognizes that the use of ages 59-1/2 and 70-1/2 as proxies for retirement may subject some distributions being used for retirement purposes to the additional tax and may trigger minimum distributions to individuals who have not retired. Modifications to these conditions would be considered if they could be uniformly applied without serious administrative difficulty.

Effective Date

The new tax rules generally would apply to all distributions from tax-favored retirement plans on or after January 1, 1986. The additional tax on early distributions would apply to all such distributions made after the date this proposal is introduced as legislation.

Analysis

The purpose of the additional tax on early distributions and of the minimum distribution rules is to assure that tax-favored retirement plans are used for retirement purposes. The tax would reduce or eliminate the tax advantages that can be obtained by using tax-favored plans to save for nonretirement purposes, including colleges expenses and the purchase of a residence.

The elimination of capital gain and ten-year averaging treatment for lump sum distributions would not subject individuals using their tax-favored benefits for retirement purposes to significant adverse tax effects. Except to the extent precluded under the minimum distribution rules, an individual receiving a large distribution from a tax-favored plan could still avoid a large tax liability by rolling over some or all of such benefits to an IRA or other qualified plan. This would be consistent with the basic objective of promoting tax-favored distributions over an individual's entire retirement period. In addition, the generally available income averaging provisions (section 1301) would continue to apply to such individuals.

The proposed modifications to the calculation of the exlcusion ratio applicable to distributions after the annuity starting date would assure that an individual (or his estate or heirs) would receive the individual's after-tax investment in the plan without additional tax. Also, the modifications would assure that an individual who outlives his life expectancy would not receive significant amounts in excess of his after-tax investment without tax. Finally, the use of standardized recovery periods would simplify the calculation and application of the exclusion ratio by taxpayers and would ease the administration and enforcement of such rules by the Internal Revenue Service.

SIMPLIFY DEDUCTION RULES FOR QUALIFIED RETIREMENT PLANS

General Explanation

Chapter 17.03

Current Law

In general, amounts paid as deferred compensation are deductible by an employer only as they are included in the income of employees. Moreover, income on amounts set aside by an employer to fund deferred compensation is generally taxable to the employer as earned. Exceptions to these general rules are provided for deferred compensation provided under qualified stock bonus, pension, profit-sharing, and annuity plans. Thus, within certain limits, employer contributions to such qualified plans are currently deductible by the employer even though employees will not be taxable until they receive distributions from the plans. In addition, the income earned on assets held in a qualified plan is not subject to tax while it remains within the plan.

An employer's deduction for contributions to a qualified plan is subject to two separate limitations. The first applies on an individual-by-individual basis and covers contributions to defined contribution plans (i.e., profit-sharing, stock bonus, and money purchase pension plans), defined benefit plans, and combinations of the two. The second limitation applies plan by plan and is based on the total contributions for the group of employees covered by the particular plan. This group-based limitation applies to pension plans (i.e., money purchase pension plans and defined benefit pension plans), profit-sharing and stock bonus plans, and combinations of the two.

The individual-by-individual limitation is as follows: (i) the contributions and other additions on behalf of an individual under a defined contribution plan for a year may not exceed the lesser of $30,000 (indexed beginning in 1988) or 25 percent of the individual's compensation for the year; (ii) the contribution to a defined benefit plan to fund an individual's annual retirement benefit may not exceed the contribution necessary, under reasonable actuarial methods, to fund an annual retirement benefit of $90,000 (indexed beginning in 1988); and (iii) the total contributions with respect to an individual covered by both a defined contribution plan and a defined benefit plan may not exceed a percentage, between 62.5 and 70 (depending on the individual's compensation), of the sum of the two preceding limits. In addition to being nondeductible, contributions in excess of these limits may also trigger disqualification of the plan.

The group-based limitation applies different limits to pension plans and to profit-sharing and stock bonus plans. An employer's deduction for contributions to a pension plan is subject to limitations based on the minimum funding standards applicable to pension plans and on certain other actuarial determinations. An employer's deduction for contributions to a profit-sharing or stock bonus plan is limited to 15 percent of the aggregate compensation paid during the taxable year to all employees in the plan. A carryforward of the unused portion of the 15 percent limit to a succeeding year is permitted, subject to an overall 25 percent of aggregate compensation limit for the succeeding year. Excess contributions may be carried forward and deducted in a succeeding year, subject to the 15 percent of compensation limit for such year.

If an employer contributes to both a pension plan and a profit-sharing or stock bonus plan, the total deduction for a year is limited to the greater of (i) 25 percent of the aggregate compensation paid during the year to the employees covered by the plans, or (ii) the amount necessary to contribute to the pension plan to satisfy the minimum funding standards for such year. An employer may carry forward excess contributions to a succeeding year, but the deduction of current and carryforward contributions for any year is limited to 25 percent of compensation paid for such year.

The group-based deduction limitation also provides special rules with respect to the deductibility of contributions to employee stock ownership plans (ESOPs), which in general are profit-sharing, stock bonus, and money purchase pension plans that invest primarily in employer securities. Contributions to an ESOP to repay principal and interest on a loan incurred by the ESOP for the purpose of buying employer securities may be deductible even though they are in excess of the generally applicable limits. In addition, an employer may be allowed a tax credit in lieu of a deduction for contributions to an ESOP for up to 0.5 percent of the aggregate compensation paid during the year to employees under the ESOP. (Certain other tax preferences also are available with respect to ESOPs: deduction for dividends paid on ESOP stock, partial exclusion of interest on ESOP loans, nonrecognition of gain on certain sales of stock to an ESOP, and assumption of estate tax liability by an ESOP.)

Reasons for Change

The limitations on an employer's deduction for qualified plan contributions are intended to restrict the tax-favored treatment associated with qualified plans for individual employees to amounts reasonably necessary to provide retirement security. Amounts in excess of these limitations are presumptively in excess of the amounts necessary to provide reasonable retirement benefits and should not be eligible for tax advantages.

The current group-based limitation on deductible plan contributions is intended to be more restrictive for contributions to plans that may be used to finance current consumption or otherwise serve nonretirement purposes. Thus, employer deductions for contributions to profit-sharing and stock bonus plans have been subject to greater restrictions, since, unlike pension plans, profit-sharing and stock bonus plans are not subject to minimum funding requirements, are more liberal in permitting pre-retirement distributions, and permit employees to defer or receive employer contributions currently.

Although profit-sharing and stock bonus plans are appropriately subject to greater limitations than pension plans, the current 15 percent of aggregate compensation limit on the deductibility of contributions to profit-sharing and stock bonus plans is not fully effective in restricting the use of these plans. The effectiveness of the 15 percent limit is undermined by the carry forward rules and, in certain situations, the ability of employers to contribute more than 15 percent of compensation for highly paid individuals and less than 15 percent for lower-paid individuals.

In addition, the 25 percent of aggregate compensation deduction limit applies only to combinations of profit-sharing or stock bonus plans and pension plans, rather than to combinations of defined contribution plans and defined benefit pension plans. As a result, an employer may make contributions to a money purchase pension plan and a defined benefit pension plan without regard to the 25 percent of aggregate compensation limit, even though money purchase pension plans are essentially equivalent to profit-sharing and stock bonus plans in that the retirement benefit provided under each is based entirely on the individual's account balance at the time of retirement.

The special tax treatment of ESOPs is also inconsistent with basic retirement policy. ESOPs are not primarily retirement plans, but rather are aimed at promoting employee ownership of employer stock and at facilitating employers in raising capital. By providing increased deduction limits and a tax credit in lieu of a deduction for certain contributions to ESOPs (and by making certain other preferential treatment available with respect to ESOPs), current law permits tax-favored treatment for plans serving nonretirement purposes.

Proposals

The 15 percent of aggregate compensation limit on deductions for contributions to profit-sharing and stock bonus plans would be eliminated. The current annual limit on the contributions and other additions for any individual in a defined contribution plan would be modified so that the contributions to a profit-sharing or stock bonus plan for any individual could not exceed 15 percent of such individual's compensation for the year. Contributions in excess of this limit would be deductible in a succeeding year subject to the 15 percent of compenstion limit for that year. There would be no carryforward of an unused limit to a succeeding year.

The 25 percent of aggregate compensation limit on deductions for total contributions to combinations of pension plans and of profit-sharing or stock bonus plans would be modified by applying the limit to combinations of defined contribution plans and defined benefit plans. Thus, if an employer maintained a money purchase pension plan and a defined benefit pension plan, the employer's deduction for total contributions to both plans would be limited to the lesser of (i) 25 percent of the aggregate compensation paid to the employees covered by the plans, or (ii) the amount necessary to satisfy minimum funding standards for the defined benefit plan.

An excess contribution to a qualified plan would generally not trigger plan disqualification, but rather would be subject to an annual tax of six percent for as long as the excess contribution both remained in the plan and was nondeductible.

The special rules for ESOPs--the tax credit and the special limits for repayments of principal and interest--would be eliminated. Thus, the deductibility of contributions to an ESOP would be governed by the generally applicable deduction limits. (In addition, the deduction for dividends paid on ESOP stock, the partial exclusion of interest on ESOP loans, the nonrecognition of gain on certain sales of stock to an ESOP, and the assumption of estate tax liability by an ESOP would be eliminated.)

Effective Date

The proposals would be effective January 1, 1986.

Analysis

The annual six percent tax on accumulated excess contributions is intended to offset the advantage of tax-free accumulation to which excess contributions are currently entitled. The tax would parallel the tax currently applicable to excess contributions to a tax-sheltered annuity contract or custodial account, individual retirement account or simplified employee pension.

MODIFY ANNUAL LIMITS ON QUALIFIED RETIREMENT PLAN CONTRIBUTIONS AND BENEFITS

General Explanation

CHAPTER 17.04

Current Law

Current law provides favorable tax treatment to funds set aside in qualified employer plans for deferred compensation or retirement savings. Among the qualification requirements applicable to such plans are restrictions on the annual contributions and benefits that may be provided with respect to any individual under the defined contribution plans and defined benefit plans of an employer. For this purpose, defined contribution plans generally include qualified profit-sharing, stock bonus, money purchase pension and annuity plans, tax-sheltered annuities and custodial accounts, and simplified employee pensions. Defined benefit plans for this purpose are limited to defined benefit pension plans. Separate annual limits apply to each individual in a defined contribution plan and to each individual in a defined benefit plan ("separate plan limits"). An "overall limit" also applies to each individual covered by both a defined contribution plan and a defined benefit plan.

The separate plan limit for a defined contribution plan provides generally that the annual contributions, forfeitures, and other additions for any individual may not exceed the lesser of $30,000 (indexed for inflation beginning in 1988) or 25 percent of the individual's compensation for such year. In determining whether the applicable limit is satisfied with respect to an individual for a year, the lesser of (i) one-half of the employee contributions for the year or (ii) the excess of the employee contributions for the year over 6 percent of the individual's compensation for the year are treated as annual additions.

Special rules permit the employees of certain tax-exempt organizations, such as educational institutions, hospitals, and churches, to benefit from contributions and other additions to tax-sheltered annuity contracts and custodial accounts in excess of the general defined contribution plan limits. Similarly, special limits applicable to employee stock ownership plans (ESOPs) permit contributions to exceed the general limits for defined contribution plans.

The separate plan limit for a defined benefit plan provides that the benefit payable with respect to an individual for a year, when expressed as an annual retirement benefit, may not exceed the lesser of $90,000 (indexed for inflation beginning in 1988) or 100 percent of the average of the individual's highest three years of compensation. The defined benefit limit is not violated if the annual benefit

459-813 0 - 84 - 13

payable to an individual who has never participated in a defined contribution plan is not in excess of $10,000. If an individual has less than ten years of service with an employer, the $90,000, the 100 percent of compensation, and the $10,000 annual benefit limits are reduced on a pro rata basis.

The overall limit coordinates the contributions and benefits that may be provided to an individual covered by both a defined contribution plan and a defined benefit plan. Calculation of the overall limit is complex, requiring that the sum of the defined contribution fraction and the defined benefit fraction for any individual subject to the separate plan dollar limits for any year not exceed 1.25. For an individual who is subject to the separate plan percentage-of-compensation limits, rather than the dollar limits, the sum of the fractions may not exceed 1.4. The numerator of an individual's defined contribution fraction is the aggregate additions made on behalf of the individual under the plan during all years of the individual's participation, and the denominator is the sum of each of the separate defined contribution plan limits that applied, or would have applied, for each of the individual's years of service with the employer. The defined benefit fraction is the individual's accrued annual retirement benefit over the applicable separate defined benefit plan limit for the year.

In the case of a "top-heavy" plan, i.e., a plan in which more than 60 percent of the total accrued benefits are for key employees (5 percent owners, 1 percent owners with $150,000 in compensation, the ten employees with the largest ownership interests, and officers), the 1.25 limit on the sum of the defined contribution and defined benefit fractions for key employees subject to the separate plan dollar limits is reduced to 1.0. If accrued benefits for the key employees are not greater than 90 percent of the total accrued benefits under the plan and if the non-key employees are provided with the required additional minimum contributions or benefits (section 416(h)(2)), the overall limit for key employees subject to the dollar limits is increased from 1.0 to 1.25.

Reasons for Change

The separate plan and overall limits on annual contributions and benefits reflect a policy that favorable tax treatment should be available only up to levels needed for reasonable retirement savings. The limits under current law, however, are unnecessarily complex and fail to limit the use of qualified plans in a consistent or equitable manner.

Calculation of the overall limit imposes a significant burden on employers and plans, and indeed may be the primary source of complexity in the retirement plan area. It requires an employer to maintain significant records for many employees and to coordinate the contributions and benefits under all of its tax-favored retirement plans.

The overall limit also creates a disincentive for employers to establish both defined contribution and defined benefit plans, since aggregate contributions and benefits to an individual subject to the separate plan dollar limits may not exceed 62.5 percent of the sum of the separate plan limits. In most situations, the maintenance of both a defined contribution plan and a defined benefit plan would better serve the interests of employees generally; younger, more mobile employees tend to be favored by defined contribution plans, while older employees, particularly those close to retirement, generally are favored by defined benefit plans.

The effectiveness of the current limits is undermined by the inconsistency in their application. The separate and overall limits fail to take into account benefits under such tax-favored plans as individual retirement accounts (IRAs). In addition, certain individuals (e.g., participants in tax-sheltered annuity contracts and custodial accounts, and ESOP participants) are permitted to receive annual contributions and benefits in excess of the generally applicable limits. Moreover, the limits consider only the contributions and benefits provided to an individual by a single employer; individuals who have accrued tax-favored benefits with more than one employer may receive total contributions and benefits far in excess of the existing limits. Finally, the limits do not effectively restrict the tax-favored benefits (as compared to the tax-favored contributions) that may be provided to an individual under a defined contribution plan.

In addition, the current limits fail to count all employee contributions and thus disregard the tax advantages such contributions receive. Although not deductible, employee contributions to a qualified plan accumulate income on a tax-deferred basis. Also, highly-paid individuals generally are in a financial position to take disproportionate advantage of the tax benefits for employee contributions to qualified plans.

Finally, the phase-in of the annual defined benefit limits over an individual's first ten years of service with an employer fails to preclude the key employee of an employer, typically a small employer, from delaying the establishment of a defined benefit plan until such employee is close to retirement. Because such a key employee generally will have in excess of ten years of service with the employer, the employee may be provided with a fully funded benefit under the defined benefit plan up to the full, unreduced annual limit. By delaying the establishment of the plan, however, the employer is able to avoid providing benefits to non-key employees who may have worked for the employer in earlier years.

Proposal

The overall limit on the annual contributions and benefits that may be provided to an individual under the defined contribution and defined benefit plans of an employer would be eliminated. For top-heavy plans, however, the existing overall limits would continue to apply.

An additional tax would be applied to taxable, annual benefits distributed to or with respect to a participant from all tax-favored retirement plans, including IRAs and tax-sheltered annuity contracts and custodial accounts. The additional tax would be ten percent of the amount by which such annual benefits exceed 1.25 times the defined benefit dollar limit in effect for the year. The additional tax would be nondeductible for income tax purposes, and losses, deductions, and credits would not be applicable against the tax.

In determining whether the separate plan limit for an employee in a defined contribution plan is satisfied, all employee contributions would be treated as annual additions on behalf of the employee. In addition, the special limits for employees of certain tax-exempt organizations participating in tax-sheltered annuity contracts and custodial accounts and for employees participating in ESOPs would be eliminated.

Finally, the phase-in of the separate defined benefit plan limit over ten years of service with the employer would be modified by providing for a phase-in of the $90,000 annual defined benefit dollar limit over the first ten years of plan participation. A minimum annual benefit would be permitted, however, for low-paid employees near retirement with significant years of service at the time plan participation commences.

Effective Date

The modifications to the annual limits on contributions and benefits would apply for years beginning on or after January 1, 1986. The ten percent additional tax would apply to tax-favored retirement plan distributions made on or after January 1, 1986.

Analysis

Eliminating the overall limit for non-top-heavy plans would eliminate a significant source of complexity and thus should promote adoption of qualified plans. It should also provide employers with a significant incentive to maintain both defined contribution plans and defined benefit plans.

The ten percent additional tax on annual tax-favored distributions in excess of 1.25 times the applicable defined benefit dollar limit for the year is an appropriate limit on an individual's annual tax-favored retirement benefits. For example, if in 1986 an individual receives tax-favored retirement benefits of $200,000, the excess of the $200,000 over $112,500, or $87,500, would be subject to the ten percent tax. This tax would recapture a portion of the tax benefits provided to the excess distributions. By applying at the individual level, rather than on an employer-by-employer basis, the additional tax also would apply to individuals who accrue excess benefits from multiple employers, without requiring significant employer involvement or administrative burden.

Of course, unless required to take a distribution into income by the minimum distribution rules, an individual may avoid the ten percent additional tax on an excess distribution by rolling over some or all of such distribution to an IRA or qualified plan.

IMPOSE TEN PERCENT TAX ON QUALIFIED RETIREMENT PLAN ASSETS REVERTING TO EMPLOYER

General Explanation

Chapter 17.05

Current Law

As a general rule, amounts paid as deferred compensation are deductible by an employer only as they are included in the income of the employee. Moreover, income from amounts set aside to fund deferred compensation is fully taxable to the employer as it is earned. Current law provides exceptions to these general rules for employer contributions to qualified defined benefit plans. Thus, within certain limits, employer contributions to defined benefit plans are currently deductible, even though employees are not taxable until they receive distributions from the plan. In addition, income generated from plan assets is exempt from tax until distributed by the plan. These tax advantages are intended to encourage the creation of qualified plans and thus to improve retirement security for employees.

Current law requires employers to fund qualified defined benefit plans on a "going concern," rather than a "termination," basis; i.e., employers must fund not merely benefits already accrued, but also some portion of the plan's projected benefits. Current minimum funding standards also provide that experience gains (e.g., better-than-expected claims or earnings experience), may not be taken into account in a single year for purposes of determining required contributions, but rather must be amortized over a fifteen-year period. As a result of these funding standards, and because employers may also receive a deduction for certain plan contributions in excess of minimum funding requirements, the funds in a defined benefit plan at any particular time may exceed the amount necessary to fund benefits accrued as of such time.

Although current law generally prohibits the use of plan assets by the employer, upon termination of a plan the employer may receive plan assets in excess of those necessary to fund fixed and contingent benefits as of the date of termination. Plan assets that revert to the employer upon termination generally are included in the employer's gross income.

Reasons for Change

Current law permits employers to gain unintended tax advantages by overfunding defined benefit plans and receiving assets back on plan termination. Although plan assets reverting to the employer are includible in its income, the employer retains the benefit of an initial deduction and of tax-deferral on the plan's income. Such tax-favored treatment is inappropriate where plan assets are not used to provide employee retirement benefits.

The use of qualified plans for nonretirement purposes is evidenced in a number of recent cases in which employers have undertaken transactions that effectively permit the employer to receive assets from a defined benefit plan while continuing to maintain a defined benefit plan for its employees. These transactions are inconsistent with the minimum funding standards for qualified defined benefit plans and undermine the security of the promised benefits in the continuing plans. Although the Treasury Department, along with the Labor Department and the Pension Benefit Guaranty Corporation, have recently issued current law guidelines regarding these transactions, the possibility for significant abuse remains.

Proposal

An additional tax of ten percent of the plan funds reverting to the employer upon plan termination would be imposed on such employer. This tax would be nondeductible for income tax purposes, and could not be offset by losses or other deductions or credits.

Effective Date

The ten percent additional tax would be applicable to qualified plan assets reverting to an employer pursuant to a plan termination on or after the date this proposal as introduced as legislation.

Analysis

The additional tax on plan assets reverting to an employer would parallel the additional tax on early distributions to individuals from tax-favored retirement plans. The additional tax also would be an effective and administratively simple deterrent to transactions designed merely to draw assets from an ongoing defined benefit plan without encouraging employers to substitute defined contribution plans for their terminating defined benefit plans.

REPEAL CASH OR DEFERRED ARRANGEMENT (CODA) PROVISIONS

General Explanation

Chapter 17.06

Current Law

In general, employees are subject to tax not only on compensation actually received but also on amounts the receipt of which is, at the employee's election, deferred until a later year. An exception to this rule of constructive receipt is provided for so-called cash or deferred arrangements (CODAs), under which an employee may elect to defer the receipt of cash compensation and have the deferred amount contributed as an employer contribution to a qualified profit-sharing or stock bonus plan. If the CODA meets certain qualification requirements, the employee is not currently taxable on the deferred amount. Contributions to CODAs are subject to the limits that apply generally to defined contribution plans. Thus, if allowed under the special nondiscrimination test for CODAs, the maximum amount that may be contributed to a CODA on behalf of any individual is the lesser of $30,000 (indexed beginning in 1988) or 25 percent of the individual's compensation.

A CODA is qualified only if the deferred amounts (1) are wholly nonforfeitable, (2) may not be distributed to the employee before the earlier of age 59-1/2, separation from service, disability, or death, and (3) satisfy the "actual deferral percentage test" (the ADP test). In general, the ADP test is satisfied if the average percentage of compensation deferred for "highly compensated employees" does not exceed 150 percent of the average percentage deferred for other employees.

Deductible contributions to an individual retirement account (IRA) are currently limited to the lesser of $2,000 ($2,250 for a spousal IRA) or 100 percent of compensation. Individual contributions to an IRA receive the same tax-deferral advantages as deferred compensation under a CODA. Thus, subject to certain limits, an individual receives a deduction for contributions to an IRA, and is taxable on such amounts only as they are withdrawn from the IRA.

Reasons for Change

The tax-favored treatment applicable to individual and employer-sponsored retirement plans is intended to enhance individual retirement security. Consistent with that policy, the ability to make deductible contributions to tax-favored retirement plans should be made available on a broad and consistent basis.

An employer's contribution of a deferred amount to a retirement plan under a CODA has the same economic and tax effect for the employee as a deductible contribution by the employee to an IRA. Despite this equivalence, the limitations on deferred compensation under a CODA are far more liberal than the IRA contribution limits. Current law thus provides tax benefits for employees of employers maintaining a CODA that substantially exceed those available to other individuals.

Unlike CODAs or other employer-sponsored plans, IRAs are available to all individual taxpayers, without regard to form of employment or occupation. IRAs, thus, are the appropriate vehicle for receipt of deductible retirement plan contributions by individuals.

Proposals

The provisions of the tax law authorizing CODAs would be repealed.

Effective Date

Repeal would be effective for contributions to a CODA on or after January 1, 1986.

Analysis

After repeal of the CODA provisions, the general constructive receipt rules of current law would apply with respect to employee cash or deferred elections. Thus, if an employee has the right to defer the receipt of some or all of his or her cash compensation and to have the deferred amount contributed to a tax-favored retirement plan, the employee would be treated as having received the deferred amounts. This would be the case without regard to whether the employee's election was before or after the period in which the employee earned the compensation subject to the election. Thus, the deferred amount would be included in the employee's gross income and the contributions would be treated as after-tax contributions to the plan. Of course, such after-tax contributions may be deductible subject to the generally applicable IRA deduction limits. See Ch. 17.01, proposing an increase in current IRA deduction limits.

MODIFY RULES FOR BENEFIT FORFEITURES

General Explanation

Chapter 17.07

Current Law

Tax-favored treatment is provided with respect to funds set aside to provide deferred compensation under profit-sharing, pension, and stock bonus plans that satisfy certain qualification requirements. Among these requirements is a rule providing that a pension plan is not qualified unless the plan provides that benefits forfeited upon the separation of an employee's service for the employer maintaining the plan will not be used to increase the benefits any other employee would otherwise receive under the plan. The forfeited amounts must be used to reduce future employer contributions to the plan or to offset plan administrative expenses. The effect of this is to deny benefit increases to employees. Forfeited benefits under a profit-sharing or stock bonus plan may be reallocated to the remaining participants and thus may be used to increase the benefits that the participants would otherwise receive.

Reasons for Change

Uniform rules governing the treatment of forfeitures should be applied to all qualified plans. Also, because forfeitures are treated as contributions and other additions for purposes of the annual limits on contributions, permitting pension plans to reallocate forfeitures among plan participants generally will benefit rank-and-file employees, and not merely highly compensated employees.

Proposal

Qualified pension plans would be permitted to use benefits forfeited by a separated employee to increase the benefits that other employees would otherwise receive under the plan.

Analysis

Under the proposal, a qualified pension plan could provide that forfeited benefits will be used to reduce future employer contributions or to offset administrative expenses, or that forfeitures will be reallocated among the remaining participants.